



ARIZONA STATE RETIREMENT SYSTEM

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Paul Matson
Director

MINUTES PUBLIC MEETING ARIZONA STATE RETIREMENT SYSTEM BOARD

Friday, May 18, 2012
8:30 A.M., MST

The Arizona State Retirement System (ASRS) Board met in the 10th Floor Board Room, 3300 N. Central Avenue, Phoenix, Arizona. Mr. Tom Connelly, Acting Chair of the ASRS Board, called the meeting to order at 8:34 A.M., MST.

The meeting was teleconferenced to the ASRS office at 7660 E. Broadway, Tucson, Arizona 85710.

1. Call to Order; Roll Call; Opening Remarks

Present: Mr. Tom Connelly, Acting Chair
Mr. Chris Harris
Professor Dennis Hoffman
Mr. Kevin McCarthy
Mr. Mike Smarik
Mr. Jeff Tyne

Absent: Mr. Tom Manos, Vice-chair
Mr. Brian McNeil

A quorum was present for the purpose of conducting business.

Mr. Paul Matson, Director, recognized outgoing Trustees, Mr. David Byers, Mr. Michael Townsend, and Mr. Steve Zeman. Mr. Matson commended them by stating they all acted honorably, ethically, professionally, and diligently in the role they played over the years they served on the Board. Mr. Matson emphasized this Board oversees approximately \$28 billion and the ASRS has approximately half a million members, having a significant impact on the state of Arizona, its economy and its public workforce.

He noted Mr. Byers served approximately seven years, and held the positions of Board Chair, Vice-chair, Operations Committee Chair, and was an External Affairs Committee member. Mr. Matson said Mr. Byers came on at a fairly tense time with respect to the internal development of the Information Technology (IT) Plan and added valuable insight, ensuring the right decisions were made. He was instrumental in most IT-oriented projects, especially promoting web development. Mr. Matson noted Mr. Byers was very results-oriented, wanting to know what value an activity would add, and he has been a change champion. He was also Board Chair last year when the ASRS had a total return over 25%, putting the ASRS in the top decile of public funds in the United States. Mr. Matson stated Mr. Byers has been a key element for the ASRS as an entity.

Mr. Matson said Mr. Townsend served on the Board approximately eight years, and held the positions of Board Chair, Vice-chair, External Affairs Committee Chair, Operations Committee Chair and Vice-chair, and member of one of the Director's Asset Class Committees. He noted Mr. Townsend was extremely diplomatic, in a way that was almost invisible, enhancing the ability

of others to work together. Mr. Matson said Mr. Townsend was instrumental in the implementation of the IT Plan where the ASRS spent significant funds to ensure both a reduction in the growth of the workforce, as well as to become more efficient in customer service. As a result, CEM, a firm that has a database of public funds, ranked the ASRS second in its peer group for service.

Mr. Matson said Mr. Zeman served on the Board approximately nine years and held the positions of Operations Committee Chair and Vice-chair, and External Affairs Committee Vice-chair. He has also served on the Investment Committee, Health Insurance/LTD Committee, and the Planning, Budget and Audit Committee. Mr. Matson noted Mr. Zeman is a "brain-storming champion," coming up with many different ideas, many of which the ASRS brought to fruition. One idea was the employer self-audit process, which received kudos from Internal Audit staff. In addition, in 2003/04 when the ASRS started doing 30-year projections on the fiscal stability of the Fund, staff and Trustees were requested by the Director to submit ideas regarding cost savings initiatives and how benefits should be structured so there were not loopholes, spiking opportunities, or iniquities. Mr. Zeman contributed the idea that an 8% accrual rate on asset refunds seemed unrealistic, and something closer to the market rate should be considered. The ASRS now has an accrual rate of 4%, which is still above market rates while enabling the portfolio to target 8%. It has been estimated that idea in present value terms will save the Trust Fund approximately \$531 million.

Mr. Matson also commented he is very excited about new Trustees, Mr. Mike Smarik, Mr. Jeff Tyne, and Mr. Brian McNeil, and looks forward to working with them. Mr. Matson then shared a portion of a letter from the Governor's Office sent to the three outgoing Trustees:

"On behalf of the state of Arizona and Governor Brewer, I would like to express my gratitude to you for the many hours of service you have given as a member of the Arizona State Retirement System Board, your hard work and without a doubt your diligence, has been a great asset to the Board. Your dedication to our great state is appreciated."

Mr. Anthony Guarino, Deputy Director and Chief Operations Officer, congratulated the outgoing Trustees on their public service. He said Mr. Townsend exhibited clarity and an unassuming leadership style that commanded the respect of staff without demanding it. He felt Mr. Townsend was truly outstanding, exhibiting poise under pressure, helping the ASRS navigate through some very tense times, in particular, with regard to the IT Plan. He echoed Mr. Matson's observation that Mr. Zeman was a font of ideas, exhibiting passion for the ASRS, and helping make the ASRS more secure and cost-efficient. Mr. Guarino noted Mr. Byers offered endless challenges to the ASRS, prompting staff to explore new, better ways to provide the best possible service to our members. Mr. Guarino said staff self-expectations were always very high under his leadership.

Mr. Patrick Klein, Assistant Director, External Affairs, commended outgoing Trustees as being devoted and diligent in their protection of the Trust. He appreciated Mr. Zeman's offering of many ideas; Mr. Byers' making the agency think about how programs could be better; and Mr. Townsend's unassuming style and insightfulness. Mr. Klein thanked all three Trustees for their service, time, talent and professionalism.

Mr. Connelly said it has been a great privilege to work with the outgoing Trustees, noting they have been exemplary in almost every behavior and virtue one would want to see in a Trustee. Through one of the toughest periods, 2007 – 2009, operationally and in the investment realm, the professionalism and diligence they exhibited provided a learning experience to Mr. Connelly. He noted the working environment of the Board was very collegial, largely due to the presence and professionalism of the three Trustees. He said they will be sorely missed.

Mr. Kevin McCarthy said he and Professor Hoffman came on board as new Trustees at about

the same time. He thanked the three Trustees for their generosity and graciousness in allowing newcomers to come up to speed, and hoped the Board could carry on their legacy.

Mr. Matson and Mr. Guarino presented each of the three Trustees with a PRIDE award.

Mr. Connelly noted the call to the public usually occurred later in the meeting; however Mr. Steve Ramos had requested to address this agenda item. Mr. Ramos, on behalf of Arizona Education Association – Retired, commended each outgoing Trustee for their service and the outstanding job they did in safeguarding and growing the Fund, especially in the last few years that were so difficult. He complimented them on the work done on the Alternate Contribution Rate. He recognized Mr. Byers for his efforts in getting the supplemental 403(b) plan out to some of the school districts. Mr. Ramos also welcomed the new Trustees.

2. Approval of the Minutes of the April 20, 2012 Public Meeting of the ASRS Board

Motion: Mr. Kevin McCarthy moved to approve the minutes of the April 20, 2012 Public Meeting of the ASRS Board. Mr. Chris Harris seconded the motion.

By a vote of 6 in favor, 0 opposed, 0 abstentions, 2 excused, and 1 vacancy, the motion was approved.

3. Presentation, Discussion and Appropriate Action Regarding the 2012 Legislative Session

Ms. Lesli Sorensen, Government Relations Officer, addressed the Board regarding the ASRS 2012 Legislative Session. Ms. Sorensen noted the Legislature adjourned sine die on Thursday, May 3, 2012. Ms. Sorensen presented the *2012 Summary of Retirement Legislation* and gave an overview of the ASRS bill, HB 2745, which passed. Among various changes, the bill repealed existing investment statutes replacing them with a single modernized statute. SB1117 passed allowing the ASRS to collect debts by levy. SB1194 passed requiring the ASRS to allocate liability to an employer who opts out of participation in the ASRS. Ms. Sorensen briefly summarized some non-ASRS bills, including HB2264, which reduces member contributions to 50 percent from 53 percent and increases employer contributions to 50 percent from 47 percent.

Ms. Sorensen noted the following confirmations to the ASRS Board: Tom Connelly, Public Member; Mike Smarik, State Representative; Professor Dennis Hoffman, Public Member; Brian McNeil, Retired Member; Jeff Tyne, Political Subdivision Member.

4. Presentation, Discussion and Appropriate Action Regarding Board Motion for Revised Contribution Rate Split

Mr. Klein addressed the Board regarding a motion with respect to the revised contribution rate split, summarizing the background. Senate Bill 1609, from the 2011 legislative session, revised the historic 50/50 percent ASRS contribution rate split for the pension and long term disability (LTD) income plans to a 53/47 percent, employee/employer, rate split effective July 1, 2011. Mr. Klein explained House Bill 2264, enacted this legislative session, reverts the current 53/47 percent contribution rate split back to a 50/50 percent split retroactive to July 1, 2011.

Mr. Klein noted, in 2011 the Board authorized a very specific contribution rate split in accordance with the ASRS Valuations and assumptions presented by Mr. Charlie Chittenden, Actuary, Buck Consultants. The 2011/12 fiscal year's approved aggregate pension contribution rate was 21.00 percent with a 0.50 percent aggregate contribution rate for the LTD income plans for a total

contribution rate of 21.50 percent. Split equally, employees and employers would have contributed 10.75 percent each beginning July 1, 2011.

In light of House Bill 2264, Mr. Klein said staff recommends the Board move to approve a revised contribution rate split for FY 11/12.

Motion: Mr. Chris Harris moved to approve the revised contribution rate split for the 11/12 FY that would provide:

- Pension 401(a) contribution rates of 10.50 percent for employees and 9.87 percent for employers, and,
- A Health Benefit Supplement 401(h) contribution rate of 0.63 percent for employers, and,
- Long Term Disability Income Plan contribution rates of 0.24 percent for employees and 0.24 percent for employers, and,
- Retroactive to July 1, 2011.

Professor Dennis Hoffman seconded the motion.

By a vote of 6 in favor, 0 opposed, 0 abstentions, 2 excused, and 1 vacancy, the motion was approved.

5. Presentation, Discussion, and Appropriate Action Regarding the ASRS Asset Allocation Study

Mr. Connelly introduced the topic, noting the Director and the Vice-chair discussed it and suggested the Board could consider waiting until the June Board meeting to take action, giving new Trustees more time to consider the topic. Mr. Matson addressed the Board regarding the ASRS Asset Allocation Study, stating the outcome will potentially have a significant impact on the Fund.

Mr. Matson gave a high-level summary, saying an in-depth presentation is planned for June. He noted the Asset Allocation Study has been reviewed at the past three Investment Committee (IC) meetings and as a result, the ASRS and NEPC developed a final recommended strategic asset allocation policy (SAAP) which incorporates strategic investment themes while providing the ability to take advantage of opportunities present in the financial markets.

Mr. Matson said the IC approved the recommended SAAP on April 30, 2012, and he highlighted the following proposed changes from ASRS' existing asset allocation policy:

- Reclassified investments into three broad asset class categories
 - Better alignment of the economic drivers for underlying asset classes
- Reduced Allocation to Public U.S. Equities and U.S. Core Fixed Income
 - Improve diversification and allow more flexibility for tactical credit opportunities
- Increased Allocation to Public Non-U.S. Equities, Emerging Markets Equity/Debt, Private Debt, Real Estate, High Yield and Commodities
 - Improve diversification and maintain a more comprehensive set of asset class opportunities

The Board made no motion.

6. Presentation, Discussion and Appropriate Action Regarding Eliminating Partial Lump Sum as a Service Purchase Payment Method

Mr. Anthony Guarino, Deputy Director and Chief Operations Officer, addressed the Board regarding eliminating Partial Lump Sum (PLS) as a Service Purchase payment method. He noted A.R.S. § 38-747(H) states the ASRS Board may accept multiple forms of service purchase payments including transfers from a 401(a) account. Using PLS funds to pay for service purchase has been interpreted to be a pre-tax transfer using 401(a) funds.

Mr. Guarino introduced Ms. Lisa King, Management Analyst, who recommended the Board accept the staff recommendation to eliminate PLS as a service purchase payment method prospectively for new service purchase requests by repealing Administrative Code R2-8-518 effective January 1, 2013. She explained PLS payments are made in full-month increments of 1 – 36 months of the Straight Life Annuity benefit. The more months of PLS taken, the larger the PLS reduction factor applied to the annuity. She said currently a member's PLS calculation is based on the member's total service credit, inclusive of the service the PLS will purchase. As a result, the PLS payment is higher and fewer months of PLS are needed to pay for a service purchase. Ms. King noted although few use this option, it has been identified that this methodology is not cost neutral and, therefore, has a negative impact to the fund.

Ms. King explained members and the agency would recognize no value if the money were spent to make the payment actuarially neutral because members would stop using that form of payment since the cost advantage to the member would be removed. She said no member would cash out a percentage of their benefit then reinvest the same amount, only to end up with the same benefit they would have had prior to the service purchase. Continuing to allow members to use PLS funds to pay for service purchase using the current calculation method benefits only a few while the cost is transferred to the remaining membership.

Motion: Professor Dennis Hoffman moved to eliminate PLS as a service purchase payment method prospectively for new service purchase requests by repealing Administrative Code R2-8-518 effective January 1, 2013.

Mr. Kevin McCarthy seconded the motion.

By a vote of 6 in favor, 0 opposed, 0 abstentions, 2 excused, and 1 vacancy, the motion was approved.

7. Presentation, Discussion and Appropriate Action Regarding the Accounting External Financial Auditing Services Request for Proposal

Ms. Nancy Bennett, Chief Financial Officer, addressed the Board regarding the Accounting External Financial Auditing Services Request for Proposal. She explained the ASRS contracts with External Financial Auditing Services to audit ASRS' Comprehensive Annual Financial Report and other financial statements every year. They also consider internal controls over financial reporting and look at compliance with certain laws and statutes. Ms. Bennett introduced Ms. Shireen Boone, Chief Procurement Officer, who noted the Arizona Department of Administration's State Procurement Office designated the ASRS as the lead procurement office for procuring "statewide financial auditing services." Ms. Boone said five offers were received for services specific to the ASRS. Only the portion of the contract pertaining to the ASRS needs to be approved by the ASRS Board. There are eight other portions pertaining to other state agencies.

Ms. Boone indicated the ASRS Evaluation Committee analyzed each proposal with respect to the following criteria: Experience, Expertise, and Reliability of Organization and Key Personnel;

Methodology and Approach to the Scope of Work; and Price, and the Evaluation Committee's consensus evaluation resulted in a recommendation to the CPO for contract awards to be made specific to the ASRS, of which the CPO concurred.

Motion: Mr. Chris Harris moved to concur with the Chief Procurement Officer's determination for contract awards to be made specific to the ASRS, as follows:

- CliftonLarsonAllen – to be retained as the primary external financial auditor and for special projects as needed.
- Heinfeld Meech to be retained as the secondary external financial auditor and for special projects as needed.

Mr. Kevin McCarthy seconded the motion.

By a vote of 6 in favor, 0 opposed, 0 abstentions, 2 excused, and 1 vacancy, the motion was approved.

8. Presentation, Discussion and Appropriate Action Regarding ASRS Board Elections

Mr. Connelly introduced the topic, noting the Director and the Vice-chair discussed it and suggested the Board consider waiting until the June Board meeting to take action, giving new Trustees more time to consider the topic. The Board indicated a desire to wait until June.

9. Presentation, Discussion and Appropriate Action Regarding the Director's Report as well as Current Events

Mr. Matson presented the Director's Report. He said no infractions were found during the Internal Audit review of internal investment trade transactions during April. Mr. Guarino presented the Operations Report noting it was one way for Trustees to keep informed if they were not members of the Operations Committee. Mr. Matson explained the various portions of the Director's Report to new Trustees.

10. Presentation and Discussion with Respect to Informational Updates from the Operations Committee Meeting on April 26, 2012

Mr. Guarino provided an update on the April 26, 2012 Operations Committee (OC) meeting, noting the OC discussed:

- a. ASRS Web Development
- b. Partial Lump Sum Payments on Service Purchase
- c. Recent ASRS Governance Audit

The next OC meeting will take place June 28, 2012.

11. Presentation and Discussion with Respect to Informational Updates from the External Affairs Committee Meeting on April 6, 2012

Mr. Klein, provided an update on the April 6, 2012 External Affairs Committee (EAC) meeting, noting the Legislature had gone sine die so the June 11, 2012 EAC meeting would be cancelled.

12. Presentation and Discussion with Respect to Informational Updates from the Investment Committee Meeting on April 30, 2012

Mr. Tom Connelly, Chair, Investment Committee (IC), requested Mr. Gary Dokes, Chief Investment Officer, provide an update on the April 30, 2012 IC meeting. Mr. Dokes discussed the ASRS Asset Allocation Study, noting it would also be a topic at an upcoming IC meeting. Mr. Dokes discussed:

- a. ASRS Asset Allocation Study
- b. Investment Management Division's (IMD) House Views

The next Investment Committee meeting will take place June 11, 2012.

13. New Agenda Items

No requests were made.

14. Call to the Public

No additional members of the public requested to speak.

15. The next ASRS Board meeting is scheduled for Friday, June 15, 2012, at 8:30 A.M., at 3300 N. Central Avenue, 10th Floor Board room, Phoenix, Arizona.

16. Adjournment of the ASRS Board

Mr. Connelly adjourned the Board meeting at 11:16 A.M.

ARIZONA STATE RETIREMENT SYSTEM

Lisa Maddox
Board Secretary

Date

Paul Matson
Director

Date